Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Chief, Examination Division, New Jersey District

from: Assistant District Counsel, New Jersey

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subject: [redacted] Dual Residency
([redacted] and [redacted])

U.I.L. 1503.03-00

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Issue

Whether a wholly owned subsidiary incorporated in the United States is considered a dual resident corporation by virtue of the fact that its parent corporation is a dual resident corporation of the United States and the United Kingdom?

Discussion

I. Introduction: Dual resident corporation status and I.R.C. §1503(d)

A corporation that is created or organized in the United States or under the laws of the United States or any State is a "U.S. corporation" or "domestic corporation." I.R.C. §7701(a)(3) and (4). The U.S. taxes a U.S. corporation on its worldwide income and allows it to deduct losses wherever incurred. The U.S. allows U.S. corporations to file consolidated tax returns with other U.S. corporations that are commonly owned. I.R.C. §1501. When two or more U.S. corporations file a consolidated tax return, losses of one corporation generally may reduce or eliminate tax on income that another corporation earns. Certain foreign countries use criteria other than place of incorporation to determine whether corporations are residents for their own tax purposes. For example, the United Kingdom treats a corporation as a domestic resident if the corporation is managed or controlled there. Finance Act, 1988, s. 66(1); De Beers Consolidated Mines Ltd. v. Howe, 95 L.T. 221 (1906)(United Kingdom citation). As does the U.S., if the United Kingdom determines a corporation to be its resident, the United Kingdom taxes the corporation on its worldwide income and allows it to deduct losses wherever incurred. Thus, a corporation that is incorporated in the United States but managed and controlled in the United Kingdom may be subject to tax on its worldwide income in both countries. Under the Internal Revenue Code, such a corporation is referred to as a "dual resident corporation." [1]

If a dual resident corporation is a resident of a foreign

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[1]A "dual resident corporation" is a domestic corporation that is subject to the income tax of a foreign country on its worldwide income or on a residence basis. Treas Reg. §1.1503-2(c)(2).

country in which the law permits the losses of such corporation to be used to offset the income of other commonly controlled resident corporations then the dual resident corporation may be able to use a single economic loss to offset two separate items of income, i.e. separately offsetting the income of its affiliates which are residents in the United States and again offsetting the income of its affiliates which are residents only in the foreign country. This practice is referred to as "double dipping." British Car Auction, Inc. v. United States, 35 Fed Cl. 123 (1996), aff'd per curiam, No. 97-5020 (Fed Cir. 1997). As a result of this tax advantage, corporations would isolate expenses in a dual resident corporation so that the corporation was operating at a loss for tax purposes. For example, this isolation of expenses allowed the consolidation of one dual resident corporation in a loss posture with two profitable companies (one in each country). The profitable corporations (not dual residents), however, reported their income to only one country.

In the Tax Reform Act of 1986, Congress enacted 26 U.S.C. §1503(d) generally in response to the problem of double dipping. Congress stated that through double dipping certain foreign investors making U.S. investments had an undue tax advantage. The elimination of double dipping was intended to put U.S. owned and foreign owned businesses on equal footing. Senate Report No. 99-313, 99th Cong. 2d Sess. 419, 420 (1986). Congress ameliorated the practice of "double dipping" by enacting I.R.C. §1503(d)(1) which states:

> "The dual consolidated loss for any taxable year of any corporation shall not be allowed to reduce the taxable income of any other member of the affiliated group for the taxable year or any other taxable year."[2]

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[2]The term "affiliated dual resident corporation" or "affiliated domestic owner" means a "dual resident corporation or domestic owner that is a member of a consolidated group." Treas. Reg. §1.1503-2(c)(10). A "consolidated group" means "an affiliated group, as defined in section 1504(a), with which a dual resident corporation or domestic owner files a consolidated U.S. income tax return. Treas Reg. 1.1503-2(c)(8).

Under §1504(a), an "affiliated group" is defined as:

(1) (A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if-

(B)(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other

A dual consolidated loss is "any net operating loss of a domestic corporation which is subject to an income tax of a foreign country on its income without regard to whether such income is from sources in or outside of such foreign country, or is subject to such a tax on a residence basis." §1503(d)(2). Therefore, generally speaking, under 1503(d), losses of a domestic corporation subject to the income tax of a foreign country cannot be used to offset the income of any of its domestic affiliates. Generally, a dual consolidated loss is determined by taking into account a dual resident corporation's items of income, gain, loss, and deduction for the taxable year, other than any net capital loss incurred by the dual resident corporation, or any carryover or carryback losses. Treas. Reg. §1.1503-2(d)(1)(i). The consolidated group that contains a dual resident corporation computes its consolidated taxable income without taking into account the items of income, gain, loss, and deduction that comprise the dual consolidated loss. Id..

The regulations may (and do) provide for exceptions to the general rule that a dual resident corporation's losses cannot reduce the income of its affiliates. I.R.C. §1503(d)(2)(B). The Temporary Regulations were published as Treas. Reg. §1.1503-2A and apply to taxable years from December 31, 1986 through October 1,1992. The Final Regulations were published as Treas. Reg. §1.1503-2 and apply to taxable years after October 1, 1992.

II. A subsidiary's place of management and control.

An issue that is not directly addressed by the Code nor the regulations is the effect of a parent's dual resident status on a subsidiary, wholly owned or otherwise. The examples provided in the regulations only concern situations in which the subsidiary is assumed a dual resident. In our case, an issue has arisen whether a wholly owned subsidiary, incorporated in the United States, is automatically considered a dual resident corporation if its parent is a dual resident corporation of both the United States and the United Kingdom.

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includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations.

(2) 80 percent voting and value test. The ownership of stock of any corporation meets the requirements of this paragraph if it-

(A) possesses at least 80 percent of the total voting power of the stock of such corporation, and

(B) has a value equal to at least 80 percent of the total value of the stock of such corporation.

Given our research to date, our office has concluded that a wholly owned subsidiary is not automatically considered a dual resident corporation simply because the parent is a dual resident corporation.

A. The effect of a parent corporation in determining a subsidiary's place of management and control.

As a threshold matter, it appears that in evaluating a subsidiary's status as a dual resident corporation the dispositive issue is the management and control of the subsidiary itself. Principles of attribution or agency do not themselves dictate a subsidiary's status under I.R.C. §1503. Generally from a legal perspective, the corporation acts for itself and is not an agent or representative of its members. Salomon v. Salomon & Co., 75 L.T. Rep. 426 (1897)(United Kingdom citation). Therefore, the country in which the management and control of a parent exists should not automatically become the country for the subsidiary based on solely on agency law. Rather, "the residence of a subsidiary company is determined in the same manner as any other company." Tax Management Portfolio 967-3rd, A-30.

As stated above, for purposes of I.R.C. §1503(d), a corporation is considered a resident of the United Kingdom if the corporation is "managed and controlled" in the United Kingdom. The determination of "management and control" in the United Kingdom is, as expected, controlled by United Kingdom authority. The seminal case in the United Kingdom on the issue of a subsidiary's place of management and control is Unit Construction v. Bullock, 3 All E.R. 831 (1959)(United Kingdom citation). In Unit Construction, a United Kingdom parent corporation had subsidiaries incorporated in Kenya. Id.. The board of directors for the subsidiaries consisted of local people in Kenya. The ordinary course business of the subsidiaries took place in Kenya. The articles of association of the subsidiaries stated that the board of directors could meet anywhere but the United Kingdom. Id.. Importantly, though, the board of directors were yielding to the board of directors of the parent company in the United Kingdom on all important issues and, therefore, the true management and control of the subsidiaries was taking place in the United Kingdom. Consequently, in holding that the Kenyan subsidiaries were managed and controlled in the United Kingdom, the court stated that "the business is not less managed in London because it ought to be managed in Kenya. Its residence is determined by the solid facts, not by the terms of its constitution however imperative." Id. at 834.

Overall, it appears that the situs of a subsidiary's management and control dos not automatically become that of its parent. Rather, the subsidiary is treated as any other corporation in making this determination. As will be seen below, though, the influence and control exerted by the parent over the subsidiary in terms of decision making is a crucial factor to consider in determining where the subsidiary is managed and controlled.

B. Factors to consider in determining a subsidiary's place of management and control.

It is clear from English law that where a corporation is managed and controlled is a question of fact. Unit Construction, 3 All E.R. at 834; De Beers, 95 L.T. at 221. Therefore, simply because the articles of incorporation states or infers that management and control is to be in a certain location, as a practical matter, it may be located somewhere else. Therefore, it is necessary to consider both how the subsidiary is supposed to be managed and controlled and how it actually is.

The most important factual consideration is who controls the policy making decisions of the subsidiary's board of directors. Where the ordinary business activity takes place is less important. The Inland Revenue Service of the United Kingdom squarely addressed this issue in its Statement of Practice issued in January 1990 ("SP 1/90"). According to SP 1/90,

> 17. Parent/ Subsidiary Relationship
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> It is particularly difficult to apply the "central management and control" test in the situation where a subsidiary company and its parent operate in different territories. In this situation, the parent will normally influence, to a greater or lesser extent, the actions of the subsidiary. Where that influence is exerted by the parent exercising the powers which a sole or majority shareholder has in general meetings of the subsidiary, for example to appoint and dismiss members of the board of the subsidiary and to initiate or approve alterations to its financial structure, the Revenue would not seek to argue that central management and control of the subsidiary is located where the parent company is resident. However, in cases where the parent usurps the functions of the board of the subsidiary (such as Unit Construction itself) or where that board merely rubber stamps the parent company's decisions without giving them any independent consideration of its own, the Revenue draw the conclusion that the subsidiary has the same

residence for tax purposes as its parent.

Consequently, it appears that when the parent simply acts in its capacity as a shareholder, the parent's situs of central management and control is not controlling. However, when the parent actually begins to control the policy decisions of the subsidiary leaving the subsidiary with no autonomy, the parent's place of management and control may dictate the subsidiary's. This is consistent with the oft-cited Unit Construction case.

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III. Conclusion

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Please note that this advice is subject to National Office post review. If you have any questions, please contact Special Litigation Assistant William S. Garofalo at (973) 645-3047 or attorney Robert T. Bennett at (973) 645-3244.

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